

NEES Settlement Agreement

Comments of WMECO Industrial Customer Group

Purpose and Overview

The Industrial Customers of Western Massachusetts Electric Company are not directly affected by the terms and conditions of the settlement agreement for New England Electric System. However, to the extent that the methods, principles and results of the NEES Agreement are used as a model, the WMEICG members will be affected by any similar agreement covering WMECO and Northeast Utilities. What's more, this agreement is conditional on similar agreements with the other electric utilities in Massachusetts. Hence, industrial customers of WMECO have a considerable stake in this agreement.

The purpose of these comments is twofold. First, the WMEICG wishes to express its support for the overall direction in the NEES Agreement. Second, the WMEICG has comments on various aspects of the NEES Agreement as they might (or might not) apply to a WMECO/NU agreement.

Direction of Movement

The Industrial Customers applaud the two primary features of the NEES Agreement. The first is a guaranteed 10% rate reduction for all customers. The second is NEES's agreement to voluntarily divest all of its generation assets. This is probably the single most important prerequisite for creating a truly competitive generation market and determining a fair level of stranded cost.

Separate ownership of generation and distribution will speed the transition to a restructured industry and will help produce an end state that is truly competitive. The goal is competition that will provide benefits for customers, as well as utilities. This will only happen in a market with robust competition. When generation and distribution are independent, pressure for a well-functioning ISO/Power Exchange will become inevitable. This will enable the market to function fairly and efficiently. New England Electric's agreement to full divestiture of its generation facilities will also lead to a true market valuation of generating plants and thereby resolve the problem of trying to calculate "stranded costs." It should produce a level of stranded cost charge that is fair to customers, as well as utilities. With this move, the basic building blocks for real generation competition are being put into place.

Comments on Specifics

Comments provided herein fall into three categories. Some aspects of the NEES Settlement Agreement are unclear or not fully defined. More specifics are required in order for all parties to understand the details of the agreement. Second, certain aspects of this agreement might be improved in agreements with other utilities. Third, the appropriate methods for another company may be different than for NEES/MECO. There is no "cookie cutter" approach.

Areas Needing Clarification

There are a number of areas in the agreement that are unclear or not fully defined. It would help to have some explanation as to why things were done as they were. For example, why was it assumed that the market value for purchase power contracts is 2.5¢/kWh in 1998, whereas, the standard offer price from NEP to Massachusetts Electric is 3.2¢/kWh? Surely, it would assist the DPU in its evaluation to have a clear understanding of what the specific details of the agreement are trying to accomplish. The areas of most concern to the WMEICG that need clarification include:

- the terms of the divestiture;
- the stranded cost calculation;
- the treatment of customers on interruptible rates and special contracts;
- the reconciliation of conservation charges; and
- the standard offer inflation cap.

Terms of the divestiture. The settlement allows NEES to divest its generation through a sale or a spin-off. The proceeds will then be used to reduce the stranded cost charge via a residual value credit. We are concerned that a spin-off, rather than an outright sale of the assets, will not produce any proceeds with which to offset any overpayments of the stranded cost charges. It should be clarified how a spin-off will produce a market valuation, and how that will be used to determine the appropriate stranded cost charge. Otherwise, customers will end up paying more than their fair share of any stranded cost.

In addition, the settlement provides for the Department to review the divestiture plan and “issue a final order on the method of sale and the reasonableness of the proceeds as part of its plan approval.” It’s unclear how the Department can rule on the reasonableness of the proceeds until after the bidding or transfer has taken place. Clarification is also needed with respect to what criteria will be used to evaluate the reasonableness of the proceeds. We expect that this will be addressed in a follow-up proceeding unless the parties want to include the criteria for review at this time.

Contract termination charge. Attachment 3, Page 6 states, “Within three months after the completion of the divestiture, NEP shall implement a residual value credit as a direct offset to the Base Contract Termination Charges authorized under this Agreement.” Clarification is needed as to when the residual value credit will be applied. Our concern is that the residual value credit might not be implemented if there is less than 100% divestiture, particularly in view of the potential unsalability of the nuclear facilities. The residual value credit should be applied on a partial basis, whenever all or any portion of NEP’s generation assets have been sold.

Massachusetts Electric’s stranded cost charge includes a termination mitigation incentive provision that appears to reward the utility (i.e., increase the contract termination charge) even if it does nothing to mitigate (i.e., reduce) the contract termination charge. The Attorney General has stated that the intention of this provision is to allow the company to earn a 9.4% return on equity if it adheres to the schedule of contract termination charges included in the settlement. Under this mechanism, if it is able to escalate the reduction in the contract termination charge, it can earn a higher return on equity. However, the settlement agreement does not provide any discussion of a connection between the

termination charge mitigation incentive and the 9.4% return on equity. The formula for calculating the contract termination charges (Attachment 1, Page 8) simply states that the termination charge mitigation incentive shall increase the variable cost component when NEP reduces the cumulative average of the contract termination charge to Massachusetts Electric below 2.8¢/kWh. As shown on Schedule 1, Page 4 (Book 2 of the settlement offer), the cumulative average termination charge falls below 2.8¢/kWh beginning in the year 2001, without any further effort by the utility to reduce the base contract termination charge. It, therefore, appears that the utility will be able to increase its earnings by taking no further action. If this is the case, it is inappropriate. If this is not the case, it should be clarified.

Interruptible rates and special contracts. The settlement states that interruptible rates, flexible rates and economic incentive rates will be closed to new customers after January 1, 1997, and service will be provided on these rates only through December 31, 2000. Thus, under the NEES settlement, it appears that interruptible customers are, in fact, forced off the existing tariffs by the end of the year 2000. After that date, the customer must elect either standard offer service or begin purchasing power from a non-regulated supplier. The settlement claims that all customers that elect to take standard offer service will receive at least a 10% reduction from current charges. It's not clear that this will be true for customers on these special rates and contracts. There is no reason why these customers should be harmed by moving to a more competitive industry. The stranded cost calculation is basically a method to protect the utilities' financial position during the transition to competition. It is based on the argument that utilities shouldn't be penalized because the rules are changing. They made certain investments because they had an obligation to serve. They want cost recovery for investments made under old world rules. Customers with special contracts and alternative rates should be given similar treatment. The utility stands to recover revenue that it wouldn't otherwise receive when those rates are terminated. This should be shared with customers. In addition, utilities should be required to negotiate a phase-out with customers on special rates rather than an abrupt termination.

Reconciliation of conservation charges. After retail access is implemented, under the terms of the settlement there is no separately-stated conservation charge. It is unclear how the revenues actually received will be reconciled to budget without such a charge. The settlement states that Massachusetts Electric will reconcile actual spending to the approved budget with a separate reconciliation for renewables and demand-side management and will carry forward any balance into the following year with an adjustment to the budget. However, since there is no conservation factor, it's not clear how they will reconcile revenues collected with actual expenditures.

Adjustments to the standard offer inflation cap. The settlement states that the inflation cap will be adjusted to exclude the fuel price index; any adjustments caused by the return on equity floor; and changes in tax laws. Changes in fuel cost and in taxes should flow through the inflation index and should therefore not be excluded.

Areas Needing Improvement

This agreement is potentially a model for similar agreements with other electric utilities in Massachusetts. There are aspects of the agreement that can be improved in subsequent agreements with other utilities to ensure that all customers, including industrial customers, get their fair share of the benefits of moving to a restructured industry. The WMEICG sees room for improvement in the following areas:

- the terms of the divestiture;

- the calculation of the contract termination charge;
- cost allocation and rate design;
- funding for conservation;
- treatment of Service Extension Discount (SED) customers;
- unbundled distribution service; and
- incentives related to transmission cost.

Terms of the divestiture. While the agreement provides for divestiture within six months after the latter of the Retail Access Date or the receipt of all governmental approvals, there is no penalty for non-compliance with this provision. Page 29 of the Restructuring Settlement Agreement states that, “If, for any reason, the divestiture is not completed within three years of the Retail Access Date, NEP shall file a report with the Department explaining the delay.” What is the effect on the utility if the divestiture does not take place in a timely fashion? One possibility would be to exclude further recovery for any non-nuclear generating plant not divested within the three-year period. Thus, for example, if the Manchester Street Station is not sold or divested within three years, the remaining undepreciated portion of the facilities will be excluded from the access charge.

Contract termination charge. Under the terms of the agreement, the fixed component of the contract termination charge will include revenues sufficient to provide an overall pre-tax rate of return of 11.18%, which will remain fixed through December 31, 2009. If the utility is able to reduce its financing cost at any point during that period, the WMEICG believes that this savings should be shared with customers. Essentially, this provides the utility with an avenue to increase its earnings, but there is no way for the customer to share in any cost savings. If a utility does not want its financing cost revisited during the transition period, then it should be required to be more aggressive in its cost savings up front.

Cost of service/rate design. The WMEICG is concerned about aspects of the settlement agreement involving cost of service and rate design that appear to disadvantage industrial customers. Attachment 2 of the settlement offer includes a distribution cost of service study used in support of the proposed retail delivery rates. Adjustments were made to reallocate costs in the study that result in higher cost to Rate G-3 (the industrial customer class). No explanation for this is provided in the accompanying text. In addition, under the terms of the agreement, all standard offer customers are guaranteed at least a 10% reduction in power cost. However, the typical bill analysis included in the agreement shows that the G-3 rate class is getting a 10% discount, but other classes are getting larger reductions. Again, there is no explanation for this different treatment. Another problem appears in the rate design of the proposed retail delivery rates. The settlement agreement states that the transmission charges and access charges will be charged on a uniform cents-per-kilowatthour basis. Transmission- and generation-related costs are traditionally allocated and charged on a demand-related basis. These are Massachusetts Electric rates, so they are not directly relevant to the Western Massachusetts Electric Industrial Customer Group. However, to the extent that this settlement is a model for other utilities in the state, the WMEICG believes there is little to be gained from rates that discriminate against industrial customers, particularly as the industry becomes more competitive.

Conservation funding. The settlement agreement includes a \$67 million annual budget for demand-side programs and renewable resources. It is not clear why these programs require funding at the same level after restructuring. This funding is directly contrary to the

idea that markets, where feasible, work better than regulation. Regulated funding of these programs will inhibit the market from developing independently. We recommend that the budget for these programs be phased out as competition develops. Nevertheless, if the current level of conservation funding is retained, the reconciliation provisions should be addressed. As discussed above, the agreement provides for a charge for renewable expenditures, but not for conservation. A conservation factor is required to track what the utility spends against how much it collects.

Service Extension Discount customers. Under the settlement, Massachusetts Electric states that it will waive the five-year notice provision for customers with service extension agreements and customers with DSM contracts without requiring repayment “insofar as it would limit the customers’ ability to purchase electricity from an alternative supplier.” However, Massachusetts Electric clearly states that it does not have to waive the advanced written notice required before a retail customer may install on-site, non-emergency generation for its own use. Since these customers will no longer be receiving any benefits, it is unclear why this provision should be retained. It is inappropriate to retain provisions that restrict the installation of new generation.

Unbundled distribution services. Page 34 of the settlement agreement states that effective January 1, 2000, Massachusetts Electric shall file with the Department a proposal to unbundle distribution services that can be provided competitively, without impairing system reliability or other system benefits. We support this proposal. It is our view that distribution service actually entails three functions. One is the distribution “wires” function, i.e., physically connecting the customer with the transmission grid. This should remain regulated. The second function is “retailing,” i.e., procuring power supply for customers. The third is energy services—including metering and billing innovations. These services can and should be provided on a competitive basis.

Under the settlement agreement, customers who do not choose an alternative supplier will be placed on standard offer service. We recommend, instead, that such customers be placed on a form of “Basic Service” similar to that discussed in the Massachusetts Division of Energy Resources proposal entitled *Power Choice*. The settlement agreement includes a provision with the same name. However, it is more of a “stop gap” measure for customers that “face an occasional hiatus between competitive suppliers.” Under the terms of the agreement, Massachusetts Electric will facilitate the continued delivery of power for such customers by providing supply through the short-term wholesale power market. This should be the default for customers who do not choose an alternative supplier. What’s more, it should be provided as a permanent option rather than an interim alternative.

A new feature of the restructured industry will be energy service companies, including aggregators, brokers, marketers, resellers, etc. These companies should function on a competitive basis. One criticism of some restructuring proposals has been that the necessary metering is not in place to allow all customers to buy power at rates that fluctuate with the short-term market. Competing companies may find innovative ways to put this metering (and other energy-related services) in place more quickly than anyone anticipates, thereby allowing even residential customers to have more control over their power usage and cost. The incumbent distribution company will have a name-recognition advantage. The sooner other companies enter this market, the better. Therefore, while we support the proposal to unbundle distribution services, we recommended that the Department consider advancing the date for unbundling distribution services to 1999.

Reconciling transmission charges. It is extremely important that as the industry is restructured, the right incentives are designed into the system to ensure that it operates as efficiently as possible. In this light, the WMEICG is concerned about the proposed

reconciling transmission charge clause. The settlement agreement states that transmission charges included in the retail delivery rates will recover the transmission charges billed to Massachusetts Electric on a fully-reconciling basis. This means that Massachusetts Electric will have no incentive to keep the transmission rates of NEP or any other transmission provider as low as possible. What's more, this will inevitably lead to cost allocation disputes, if the transmission and distribution services are provided by the same or an affiliated entity. One possible way to resolve this concern would be to require that transmission increases over the present cost be subject specifically to the inflation cap.

Areas Specific to Northeast Utilities/ Western Massachusetts Electric Company

Some of the principles in the NEES agreement are likely to be generic and applicable to all utilities in Massachusetts, such as the treatment of above-market purchase power costs and the return on equity used for the recovery of stranded costs. Other parts may be utility-specific. For example, Massachusetts Electric pays for generation and transmission on the basis of New England Power's wholesale power rate, whereas WMECO is allocating costs based on the Northeast Utilities Generation and Transmission agreement. These differences must be addressed in any restructuring proposal that is intended to be used as a model for all utilities in the state. What's more, most of the larger companies operate in more than one state.

Restructuring for WMECO and Northeast Utilities might mean something quite different than for New England Electric. NEES already has a form of corporate separation between generation and distribution, while Northeast Utilities is a group of vertically integrated companies. New England Electric has agreed to spin off its generation, which would leave it in the distribution business. Northeast Utilities, on the other hand, may find it easier to spin off its distribution properties, sell part of its non-nuclear generation and remain in the generation business, particularly if it cannot sell its ownership interests in the nuclear plants. This path would allow for a Massachusetts-only solution, wherein WMECO could become an independent company.

NEES has relatively little nuclear capacity. Northeast Utilities, on the other hand, has a large amount of nuclear capacity. The settlement agreement appears to assume that NEES may not be able to sell its interest in nuclear generation facilities. It is not clear, at this point, how to develop a proposal that includes divestiture of generation for Western Massachusetts Electric, taking into account the significant holdings of nuclear facilities. An additional element of uncertainty is added by the recent problems with NU's nuclear plants. If some NU nuclear plants are shut down, the market price of power in New England is likely to increase. The effect of this will be to reduce stranded cost, because it would lessen the difference between the actual embedded cost of utility supply over the market value of kilowatthours.

Finally, cost allocation and rate design are very utility-specific. Different utilities in Massachusetts use different demand allocators (e.g., Massachusetts Electric uses the WHAM-D method, while WMECO uses the "break even POD" method). This affects the allocation of transmission and stranded cost charges.

Conclusion

The WMEICG supports this agreement with the qualifications expressed above. This agreement represents an important advance toward a restructured industry that will provide customers with greater control over their cost of power. In ruling on this particular

settlement, the DPU will explicitly and implicitly be deciding a number of policy issues that will affect customers. It is crucial to understand the “why” of the settlement provisions both for this agreement and for those that follow.